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STATEMENT OF  
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ON

"REASONS FOR THE DISPARITY BETWEEN  
COSTS QUESTIONED BY AUDITORS  
AND AMOUNTS AGENCIES DISALLOW"

Mr. Chairman and members of the Subcommittee, I am pleased to appear before you today to discuss the results of our review of certain aspects of the audit resolution process. In September 1982, you asked GAO to determine why there is a disparity between costs questioned by auditors and costs which program officials disallow.

Audit resolution has been a concern of ours for several years. We have issued 4 reports on the subject and have testified at several hearings. Due in large part to the efforts of your Subcommittee, the process of resolving auditors' findings has been improving over the years. OMB has issued a revised Circular A-50 on audit followup, and in 1983 the Comptroller General issued a standard on audit resolution in his Standards For Internal Controls In The Federal Government. As our most recent review shows, however, additional improvements should be made.

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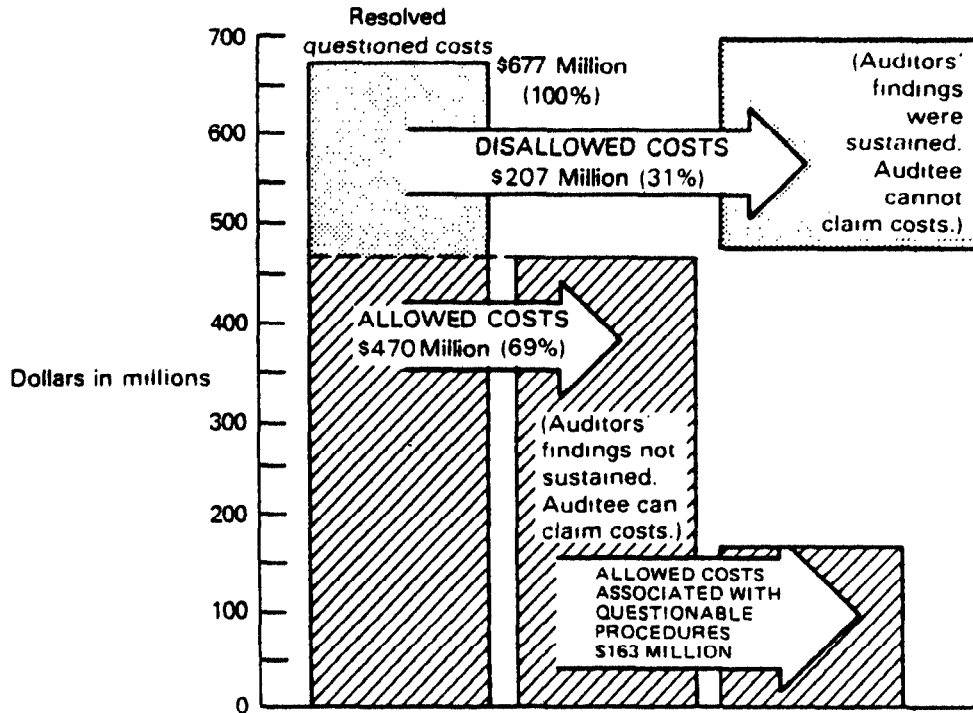
## THE AUDIT RESOLUTION PROCESS

The basis for your request that GAO review the audit resolution process was that the Congress is being told that auditors have questioned billions of dollars in costs incurred by grantees and contractors, but by the time the audit resolution process is completed, only a small fraction of those questioned costs are disallowed by agencies and returned to the federal government. There are at least four reasons for this disparity:

- the audit resolution process,
- the reversal of decisions to disallow costs,
- auditor errors, and
- the way questioned costs are reported to the Congress.

The first reason involves the audit resolution process itself. We looked closely at the audit resolution process in our recent review. We took a sample of 325 audits that were resolved in fiscal 1981 and 1982 in 6 major federal civilian agencies. We analyzed 586 findings generated by those audits that involved costs questioned by auditors totaling \$677 million.

How questioned costs were resolved<sup>a</sup>



<sup>a</sup>"Resolved" as defined by OMB.

As the chart we have prepared shows, program officials reviewed the \$677 million in questioned costs and agreed with the auditors that \$207 million should be disallowed and returned by grantees and contractors to the government, but determined that \$470 million should be allowed to be retained by the audited entities.

In reviewing the procedures followed and decisions reached by program officials on the \$677 million in questioned costs, we found that the majority of the decisions to allow \$470 million that had been questioned were appropriate. However, out of \$470 million in costs which program officials allowed, we questioned the procedures they used to allow costs in 112 cases totalling \$163 million. We do not mean to say that these amounts are now due back to the government. We only show the dollars in order to quantify the problem.

We question program officials' decisions to allow costs:

- When the decisions did not hold the auditee accountable for deficiencies.
- When the decision did not address the auditor's issues, and
- When the decisions were not supported by appropriate justification as required by OMB guidance.

We found a number of decisions to allow questioned costs based on a proposed future reaudit. Such audits may not cover the same costs originally audited or may not occur at all. As an example in one case involving an EPA audit of a grant to the Ohio Pollution Control Agency, officials allowed \$720,000 of questioned costs based on a proposed reaudit. However, EPA Inspector General auditors told us the reaudit would never occur because their future workplans do not include audits of that type of grant.

In other cases, we questioned allowing costs on the basis of corrective action plans. We believe such plans are good, but are not a proper reason to excuse an auditee's liability for past improper expenditures or to allow costs before the corrective action has taken place.

Other questionable procedures used by program officials to allow costs consist of:

- basing decisions on inadequate documentation from auditees,
- accepting auditee certifications that costs incurred were proper in place of documentation, and
- not justifying decisions in writing as to why they disagreed with the auditors.

I have attached several cases as an appendix to my testimony that provide examples of the various questionable procedures we noted in our review.

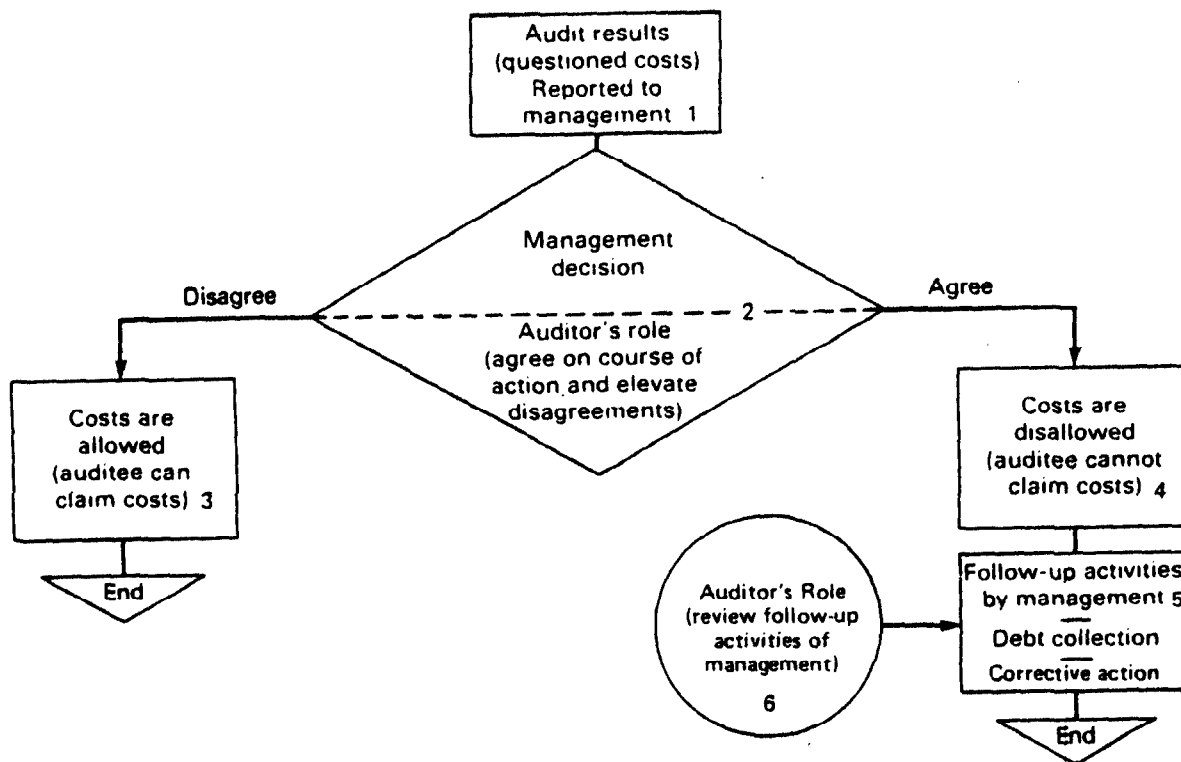
MORE AUDITOR PARTICIPATION  
IN THE AUDIT RESOLUTION  
PROCESS IS NEEDED

A second reason for the disparity is that even after a determination has been made that the costs questioned by auditors should be disallowed, the decision is sometimes reversed by appeal action initiated by the auditees, or a change of mind on the part of a program official. If I may refer you to our chart on How Questioned Costs Were Resolved, you will note that program officials initially disallowed \$207 million of the \$677 million in questioned costs. However, this amount was

later reduced by \$44 million without first informing the auditors or otherwise giving them an opportunity to agree or disagree. We believe auditors need to be aware of decisions made by program officials regarding questioned costs, and also be aware of later changes to these decisions.

The auditors would have been aware of these reversals if they followed the Comptroller General's audit resolution standard, which gives auditors a role in followup. Currently agencies are expected to follow both OMB Circular A-50 and the Comptroller General's guidance, however, there is a difference between OMB's definition and the Comptroller General's definition of "resolution" which needs attention. Stated briefly, OMB considers "resolution" to be the point at which program officials reach agreement with auditors on a course of action. The Comptroller General, however, has stated that reaching that decision is only a part of resolution and that resolution includes following up to insure that promised corrective actions are taken. To illustrate the difference in the definition of audit resolution I direct your attention to Chart 2.

### Audit Resolution Process



GAO defines resolution to include all 6 of the steps illustrated by the numbered boxes in the chart. However, OMB considers auditors' findings and recommendations resolved after a management decision has been made on how to handle the auditors' findings and recommendations as shown in box number 2.

We believe OMB should reconsider its use of the term resolution and bring it in line with the broader definition which has been established by the Comptroller General--a definition that provides an important follow-up role for auditors. We also believe agencies should not call something resolved in their reports to the Congress, or in other reports, until corrective action has been taken.

### AUDIT QUALITY

The third reason for the disparity that I want to discuss today is audit quality. GAO is currently engaged in a pilot effort that will lead to the review of the overall performance and operation of each Office of Inspector General. Because of this and because assessing audit quality is a time-consuming task, we did not assess audit quality in the 325 cases in our recent review of audit resolution. But, I may add, we did not find that poor audit quality surfaced frequently as a reason program officials used for allowing costs. However, we did find several cases where auditors questioned costs erroneously because they made errors in computations or misinterpreted regulations or agency records. In each of these cases, which totalled \$4.9 million, the errors were confirmed by the auditors when program officials reviewed the cases, and the questioned costs were allowed.

### IG REPORTS TO THE CONGRESS

The fourth reason for the disparity lies in the amounts of questioned costs reported by inspectors general to the Congress. There is no standard definition of what constitutes a questioned cost, so each inspector general uses their own definition. Some report questioned costs as those which are ineligible for payment by reason of a violation in a



law, resolution, or grant or contract provision. These questioned costs tend to have a higher probability of being disallowed by an agency, and of resulting in funds being returned to the government. Other inspectors general include in their questioned costs amounts which have not been properly documented by a grantee or contractor, and costs associated with proposed management improvements. These tend to be less conducive to the recovery of federal funds.

The point is that several different categories of questioned costs--with various degrees of probability of yielding dollar recoveries to the government--are being reported to the Congress. Moreover, some inspector general reports have portrayed disallowed costs as savings when they in fact may not represent savings at all. We believe this raises the expectations of the Congress as to the amount of funds that will be returned to the government.

I would like to elaborate on this issue. The Inspector General Act of 1978 requires IG's to report semi-annually on the results of their work. All the IGs in our review include information on the audit resolution process in their reports. The problem is that the data is not consistent among the various reports. As I mentioned, there is no uniform definition of what a "questioned" cost is. OMB has not provided such a definition in their Circular A-50.

Since inspectors general are using their own definitions of questioned costs, it is difficult to interpret and compare audit resolution data. For example, the inspectors general at HHS, DOT, and EPA report questioned costs when they believe the costs are ineligible because a law, regulation, grant or contract provision has been violated. However, questioned costs are considered by the IG's at Labor and Education to be those costs that are unsupported or inadequately supported by documentation. Inspectors general who report only questioned costs arising from violation of laws, regulations, grant or contract terms will undoubtedly show a better track record for having their questioned costs sustained than those that include costs questioned because documentation was not available.

Another problem that arises from the lack of uniform definitions that some inspectors general are including management improvement findings in their questioned costs. In our recent review, we found that reports to the Congress included questioned costs of \$51 million related to management improvement findings. These findings are important because they improve agency operations, but they do not result in the return of funds to the government.

We believe questioned costs should represent potential debts to the government. We believe the inspector general reports to the Congress should distinguish between costs ineligible because a law, regulation, grant or contract provision is

violated, and costs questioned for lack of documentation. We believe recommended management improvements should be labeled as such, and not included as questioned costs.

We have another problem with the reporting of audit resolution data to the Congress. Disallowed costs sometimes are portrayed as savings to the government, and this is misleading because such costs do not always result in a return of funds to the government. In some cases, disallowed costs are later reduced in amount by program managers or by appeals by grantees or contractors that are sustained. These subsequent reductions are not usually reported to Congress nor are previously reported amounts updated. While OMB has defined disallowed cost, it has not defined "savings." We believe savings only occur when funds are recovered or withheld from the auditee. Savings can only be determined at the end of the resolution process and not as some intermediate point in the resolution.

#### OUR RECOMMENDATIONS

As a result of our review we are recommending in our report to you that the agency heads we audited should insure that program officials give proper attention to issues raised by the auditors, and eliminate or constrain the use of reaudits, certifications, and corrective action plans as the basis for allowing costs.

We are recommending that IG's become more involved in the audit follow-up by insuring compliance with the Comptroller General's audit resolution standard.

We recommend OMB's Director incorporate our recommendations into Circular A-50 and establish definitions of questioned cost and savings for purposes of reporting audit resolution data to Congress. OMB should also revise Circular A-50 to include the Comptroller General's definition of audit resolution.

Mr. Chairman, we hope our report will be useful in improving audit resolution. We look forward to working closely with this Subcommittee on this matter in the future as we have in the past. We thank the Chairman for these useful hearings which stimulate needed attention to this issue. This concludes my statement. I will respond to questions at this time.

EXAMPLES OF CASES WE REVIEWEDEXAMPLES OF ALLOWANCES WE QUESTIONPlanned reaudit

- In an audit of an EPA grant to the Van Buren Board of County Road Commissioners in Michigan, auditors questioned about \$166,000 because access to records was denied and financial procedures were questionable. Agency managers allowed the costs based on plans to reaudit once access to records was obtained. We believe allowing costs based on a planned reaudit is improper because the proposed subsequent reaudit may never be performed or may not address the original questioned costs.
- An OIG audit of a USDA Food and Nutrition Service grantee questioned about \$1.2 million in reimbursement claims because of problems in the grantee's accounting system. Program officials allowed the costs based on a proposed reaudit which we believe is improper for the reasons stated in the previous case.

Corrective action plan

- DOT's audit of Westchester County, New York, questioned a grant of over \$150,000 used to purchase bus stop signs which had not been installed. Program officials allowed the costs. The grantee was asked to provide within 6 months a detailed inventory list and certification of which signs were being used. Although more than a year had passed since that decision, the grantee had not furnished the list. Thus, program officials did not know if the signs were installed, but had taken no action to recover the costs. We believe the corrective action plan was not effective in getting the desired results. We believe the procedure to allow the costs was questionable because the costs should not have been allowed until the planned corrective action had taken place.
- A Department of Education audit questioned over \$1.9 million in loan funds. Collection of over \$1.8 million in loans was doubtful due to the auditee's poor collection practices and over \$60,000 in loan funds were retained by collection agencies as fees, which the auditors believed was prohibited by the program regulations. Although no corrective action plan was developed, program officials disallowed only \$32,000 of the funds because they believed the auditee was making a good effort to correct past deficiencies and some retention of collections by a collection agency is not unusual. We believe that allowing cost without a formal corrective action plan that documents the auditee's remedial actions tied to deadlines, is a questionable procedure.

Eligibility of costs

- In an EPA audit, the OIG questioned about \$765,000 because the grantee incurred the costs before the grant award. The grantee stated the costs were incurred at EPA's request and, therefore, should be eligible for grant participation. The grantee requested a waiver of the questioned costs, but program officials decided the waiver was unnecessary because, based on agency policy, the costs were eligible. The costs were allowed although an agency headquarters official stated the agency had no written policy making the costs eligible. Program officials could not cite the agency policy which regarded the costs as eligible. We consider the procedure to allow the costs questionable because program officials did not adequately explain why the costs were eligible.
- In the Department of Labor's CETA program, program officials can allow questioned public-service employment costs under certain conditions, one of which is that the magnitude of the cost allowed cannot be substantial. However, the regulation did not specify how to determine what is "substantial." This provision was used in one audit to allow about \$18.2 million in costs questioned because Honolulu, the CETA grantee, could not document the eligibility of program participants. We question the procedure used because program officials did not adequately explain how they decided \$18.2 million was not a substantial amount of money.
- A Department of Education audit of the Puerto Rico Department of Education questioned about \$12.3 million in expenditures because the auditors said program requirements were violated. The total amount was recorded as allowed when the auditee filed about a \$12.3 million lawsuit over another unrelated issue. Without addressing the substantive issue raised by the auditor, the agency negotiated a settlement agreement which provided that the auditee would drop the lawsuit and the Department would not disallow the questioned costs. We question the decision to regard these costs as allowed. By characterizing the costs as allowed, for the purposes of this settlement, program managers undermine the validity and integrity of the auditors' original determination that the government should not be charged these amounts. We believe that since program officials never made a decision disagreeing with the audit findings, the questions should have been reported as disallowed. In this case, it would also be appropriate to report why the amounts were not recovered--that is, they were used to settle an unrelated suit with the grantee.

Administrative decision

- In three audits of a Metropolitan Atlanta Rapid Transit Authority construction project funded by DOT, transportation auditors questioned about \$10.5 million and classified as unauditible about \$5.9 million, primarily for improprieties

in allocating project costs. Program officials allowed the costs. According to officials, under the contract terms the government would not participate in costs above a specified limit which the contractor was expected to exceed. Consequently, the amount of questioned and unaudited costs, if sustained, would not likely result in funds returned to the government. We question the procedure used in this case because the findings were not resolved based on the issues raised by the auditors. We believe the integrity of the audit finding requires that the propriety of the costs be determined, even if the amounts cannot be recovered.

--An audit of a grant made by HHS's Office of Human Development Services (OHDS) questioned \$17,000 because the grantee failed to satisfy matching requirements. OHDS officials allowed the costs because the grantee had been terminated. We question this procedure because OHDS officials did not determine the cost's allowability but decided instead on the basis of the termination, although the grantee might have owed money to the government.

--In an HHS audit of a National Institutes of Health (NIH) contractor, auditors reported a hospital under contract did not document about \$34,000 in costs related to salaries and wages. The costs were initially charged to other activities and subsequently transferred to this contract. The auditors questioned whether the costs were distributed accurately. NIH program officials allowed the costs, which they said resulted from "system deficiencies." We question the procedure used to allow the costs because it inadequately dealt with the auditee's deficiency that was the basis for the auditors' original questioning of the costs.

--In an audit of a Department of Education grantee, program officials allowed over \$200,000 in findings because another office in the Department was investigating the case. We believe the audit should not have been closed until a determination could be made based on the case's merits.

#### Written justification

--A CPA audit of an EPA grantee questioned \$72,593 in grantee costs because during the final inspection EPA engineers had determined the costs were ineligible. The costs were related to equipment which had not been operated in 4 years. The grantee disagreed with this assessment. Program officials notified the grantee on two occasions they agreed with the auditors' assessments that the costs were ineligible. In the final determination letter to the grantee, however, the program official stated that these costs were eligible for EPA reimbursement. We question this procedure because we could not find documentation to support EPA's basis for allowing the costs. EPA officials said they remembered

negotiating with the grantee over several months and finally reinstated the costs. However, no documents were available to support this decision.

#### Documentation or auditee certifications

- In an audit of a Department of Education grantee, agency auditors could not decide the reasonableness of about \$13.1 million in expenditures because the grantee had an inadequate financial management system. But program officials allowed the costs, based on reconstructed workpapers submitted by the auditee, even though the auditors found numerous problems with the grantee's data when they examined it. We believe the procedure to allow the costs was questionable because, in our opinion, program officials did not adequately address the auditors' issues.
- In a Department of Education audit, auditors questioned over \$5 million in contract expenditures by the University of Pittsburgh because it did not meet federal requirements for supporting documentation. Resolution officials allowed the costs when the university certified the costs were accurate, valid, and commensurate with work performed. We question the use of certifications in lieu of records which the auditee was required to maintain.

#### EXAMPLES OF AUDITOR ERRORS

- A city auditor conducting an audit of the Human Resources Administration in New York City made a mistake in calculating the amount of an HHS grantee's in kind contributions which caused the auditor to overstate the questioned costs by \$993,000. Program officials originally sustained the costs, but afterward discovered the error and reduced the disallowance by the amount of the error.
- An OIG audit of the Wisconsin Department of Natural Resources, an EPA grantee, questioned \$69,710 of grantee costs because the grantee failed to obtain prior approval for certain purchases. Later, in a memo to program officials, the OIG stated that these costs were questioned as a result of an error by the auditor.