STATE HIGHWAY AGENCIES NEED TO EMPLOY INDEPENDENT AUDITORS FOR --ETC(U)

OCT 81

UNCLASSIFIED GAO/AFMD-82-5
Dear Mr. Secretary:

Subject: State Highway Agencies Need to Employ Independent Auditors for Audits of Federal Funds (AFMD-82-5)

We recently reviewed the Department of Transportation's (DOT's) plan for auditing Federally funded State highway programs. We did this because we were concerned that this plan could violate the independence standard for Government auditing contained in the Comptroller General's "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions."

After our review, we concluded that the plan is unacceptable because it violates the independence standard for Government auditing. We based our conclusion on the fact that DOT plans to let State highway agencies' internal auditors rather than auditors independent of and external to the organizations be the principal auditors of Federal funds received. We believe the use of independent auditors will reduce the potential for compromising audits of Federal funds and help minimize the possibility of fraud and abuse.

OBJECTIVE, SCOPE, AND METHODOLOGY

Our objective was to determine if DOT's plans for conducting Federally required audits would impose any organizational impairments to independence. To accomplish this, we interviewed officials in headquarters and regional offices, reviewed audit policies and procedures of the Federal Highway Administration and the Office of Inspector General, and interviewed State highway agency officials in the 50 States and the District of Columbia.

AUDITING PLANS FOR FEDERAL HIGHWAY PROGRAM

OMB Circular A-102, Attachment P, requires Federal grant recipients to arrange for independent audits of their operations at least every 2 years. Although DOT and its Federal Highway Administration recognize that internal audit groups cannot be considered independent for Attachment P audits, the Administration has drafted

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regulations permitting State highway agencies to use their own internal audit staffs for two basic reasons. First, it is convenient for both the State agencies and DOT. It permits State highway agencies to use available internal audit groups so DOT can use its auditors in other areas. Second, since DOT has ruled that the costs for audits of Federal funds provided to these agencies is not reimbursable from the Federal-Aid Highway Program, this arrangement does not require State agencies to absorb the costs of external audits.

In the past, audits of State Highway agencies' use of Federal-Aid Highway Program funds were conducted jointly by the internal audit groups and the Federal Highway Administration's auditors. These audits were cooperative efforts with the Administration's auditors serving as independent, principal auditors.

However, recently the Administration's auditors were assigned to the relatively new Office of the Inspector General. With their reassignment to a Department-wide position, it was decided that these auditors would no longer be used as they had been because of other audit priorities. Therefore, DOT must rely on other auditors to audit State highway agencies' use of Federal funds.

While grantees' audit costs generally are reimbursed by the Federal Government according to an indirect cost rate (OMB Circular A-87), they are not under the Federal-Aid Highway Program. It is DOT's position that audit costs associated with a State's administration of the Federal-Aid Highway Program are nonreimbursable and that Attachment P audit costs are part of overhead costs and therefore are associated with the administration of a State highway department. This position is based on 23 U.S.C. 302(a), the provision of the Federal-Aid Highway Act which requires that a State have a highway department "suitably equipped and organized" to carry out the act. If the Administration required the use of auditors external to the organization in its regulations, the Administration might impose financial burdens on the State agencies and governments. Consequently, the Administration chose to let State highway agencies use their internal audit groups as principal auditors.

Many State highway agencies already are acting on the draft regulations and plan to use their own internal audit groups to satisfy the Federal audit requirement. In fact, at the time of our audit, 23 agencies planned to use internal auditors. Twenty other agencies had not yet decided how they will meet the audit requirement, while the remaining highway agencies planned to use external auditors or certified public accountants to perform part or all of these audits.

POSSIBILITY OF COMPROMISING AUDITS

If DOT carries out its plan to allow State highway agencies to engage their own internal auditors as the principal auditors of
Federal funds under Attachment P, the auditing standard relating to independence would be compromised. According to the standard, the internal auditors in this case could not be presumed independent since they are organizationally located inside the State agencies. This organizational placement does not ensure that the auditors will be granted maximum independence to conduct their audits objectively and to report their conclusions without fear of censure or reprisal.

As mentioned earlier, OMB Circular A-102, Attachment P, requires Federal grant recipients to arrange for independent audits of their operations at least every 2 years. Although the Circular does not define independent, it requires that audits be performed in accord with generally accepted government auditing standards (GAO's "Yellow Book"). The detailed discussion of the standards for audit independence as well as Attachment P are provided as enclosures I and II.

To help achieve maximum independence, the standard states that the auditors should not be part of the organization under audit. In auditing State highway agencies, State auditors, State legislative auditors, or certified public accountants outside the highway agency are presumed to be independent for the purpose of auditing for the Federal Government assuming there are no personal or external impairments. The State highway agencies' own internal auditors cannot be considered independent when they audit their own organizations for the Federal Government.

CONCLUSIONS AND RECOMMENDATIONS

Internal auditors' work is very useful to Federal agencies. Frequently, their work results in significant improvements which reduce costs and improve controls. Further, internal auditors can and have directly assisted principal, external auditors in performing Attachment P audits for the Federal Government.

However, the main objective of internal auditors is to serve the organizations to which they report. This can impair their ability to be objective in citing violations by the State highway agencies they serve. Since it is generally recognized that audits of Federal-Aid highway programs can lead to State agencies owing the Federal Government significant amounts, it would be in the Government's and DOT's best interest to require State agencies to arrange for independent audits.

The independent audit requirement can be met in several ways and the costs can be minimized. Regardless of who the external auditor is—whether from the Office of Inspector General, the State, or a public accounting firm—audit costs can be minimized by fully using the internal auditors' work after appropriate tests are made. If the reimbursement issue becomes an obstacle to obtaining independent audits even after efforts to ensure that audit
costs are minimized, DOT may want to reexamine the position that audit costs for the Federal-Aid Highway Program are not allowable Federal costs.

Since the State highway agencies already are beginning to act on the draft regulations and since this is a matter that directly affects the control of Federal funds, we believe this is a matter for your immediate attention. Officials of both the Federal Highway Administration and the Office of Inspector General informed us that they will begin acting to overcome the independence problem.

In view of the fact that States are already acting on the draft regulations, we recommend that you direct the Administrator of the Federal Highway Administration to immediately change the draft regulations and inform State highway agencies of this change so that they will engage principal auditors external to their organizations (such as State auditors, State legislative auditors, or certified public accountants). These external auditors should fully test and maximally use the internal auditors' work to reduce costs and avoid duplication.

As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations. You must send the statement to the Senate Committee on Governmental Affairs and the House Committee on Government Operations within 60 days of the date of this report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made over 60 days after the date of this report. We would appreciate receiving copies of these statements. We are sending copies of this report to the Director of the Office of Management and Budget, the Administrator of the Federal Highway Administration, the Inspector General, and interested congressional committees.

We appreciate the courtesies and cooperation extended to our representatives during the review. We are looking forward to receiving your comments concerning the matters discussed in this report.

Sincerely yours,

W. D. Campbell
Acting Director

Enclosures - 2
STANDARDS FOR AUDIT OF GOVERNMENTAL ORGANIZATIONS, PROGRAMS, ACTIVITIES, AND FUNCTIONS - INDEPENDENCE

The second general standard for government auditing is:

- In all matters relating to the audit work, the audit organization and the individual auditors, whether government or public, must be free from personal or external impairments to independence, must be organizationally independent, and shall maintain an independent attitude and appearance.

This standard places upon auditors and audit organizations the responsibility for maintaining independence so that opinions, conclusions, judgments, and recommendations will be impartial and will be viewed as impartial by knowledgeable third parties.

Auditors should consider not only whether they are independent and their own attitudes and beliefs permit them to be independent but also whether there is anything about their situation that might lead others to question their independence. All situations deserve consideration since it is important not only that auditors be, in fact, independent and impartial but also that knowledgeable third parties consider them so.

Public accountants will be considered independent if they are independent under the AICPA Code of Professional Ethics.

Auditors need to consider three general classes of impairments to independence: personal, external, and organizational. If one or more of these affect their ability to do their work and report their findings impartially, they should decline to perform the audit. If the auditors are employees of the audited entity, they should state that in a prominent place in the audit report.

Personal Impairments

There are circumstances in which auditors cannot be impartial because of their view or personal situation. While these impairments apply to individual auditors, they may also apply to the audit organization. These circumstances include, but are not limited to, the following:

1. Official, professional, personal, or financial relationships that might cause the auditor to limit the extent of the inquiry, to limit disclosure, or to weaken audit findings in any way.

2. Preconceived ideas toward individuals, groups, organizations, or objectives of a particular program that could bias the audit.

3. Previous involvement in a decisionmaking or management capacity that would affect current operations of the entity or program being audited.

4. Biases, including those induced by political or social convictions, that result from employment in, or loyalty to, a particular group, organization, or level of government.

**GAO Note:** These standards were issued by the General Accounting Office on February 27, 1981.
5. Subsequent performance of an audit by the same individual who, for example, had previously approved invoices, payrolls, claims, and other proposed payments.

6. Subsequent performance of an audit by the same individual who maintained the official accounting records.

7. Financial interest, direct or substantial indirect, in the audited entity or program.

**External Impairments**

Factors external to the audit organization can restrict the audit or interfere with an auditor's ability to form independent and objective opinions and conclusions. For example, under the following conditions an audit will be adversely affected and the auditor will not have complete freedom to make an independent and objective judgment:

1. Interference in the assignment of audit personnel.

2. Restrictions on funds or other resources dedicated to the audit organization.

3. Authority to overrule or to influence the auditor's judgment as to the appropriate content of an audit report or selection of what is to be audited.

4. Influences that jeopardize the auditor's continued employment for reasons other than competency or the need for audit services.

**Organizational Impairments**

Auditors' independence can be affected by their place within the structure of the government entity to which they are assigned and also by whether they are auditing internally or auditing other entities.

**Internal Auditors**

A Federal, State, or local government auditor may be subject to policy direction from persons involved in the government management process. To help achieve maximum independence, the audit function or organization should report to the head or deputy head of the government entity and should be organizationally located outside the staff or line management function of the unit under audit.

Auditors should also be sufficiently removed from political pressures to ensure that they can conduct their audits objectively and can report conclusions objectively without fear of censure. Whenever feasible, they should be under a personnel system where compensation, training, job tenure, and advancement are based solely on merit.

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1 For example, an individual performs a substantial part of the accounting process or cycle, such as analyzing, journalizing, posting, preparing adjusting and closing entries, and preparing the financial statements, and him/her performs an audit. There may be instances when the auditor acts as the main processing center for recording transactions initiated by the auditor and the auditor acknowledges responsibility for the financial records and financial statements; however, in these instances the independence of the auditor is not necessarily impaired.
If the above conditions are met, and there are no personal or external impairments, the audit staff should be organizationally independent to audit internally and free to report objectively to top management. The main objective of an internal audit staff is to serve the entity. Therefore, internal auditors may not be considered independent of the entity by third parties while auditing within their organization. While the internal auditor may not be considered independent, the external auditor, in auditing the entity, should use the internal auditor's work to the extent feasible after appropriate tests are performed.

When organizationally independent internal auditors perform audits external to the government entity to which they are assigned, they may be considered independent of the audited entity and should be free to objectively report the findings.

External auditors

Government auditors who are elected and legislative auditors auditing executive entities usually are free of organizational impairments when auditing outside the government entity to which they are assigned.

Government auditors may be presumed to be independent of the audited entity, assuming there are no personal or external impairments, if the entity is:

1. A level of government other than the one to which they are assigned (Federal, State, or local).
2. A different branch of government within the level of government to which they are assigned (legislative, executive, or judicial).

Government auditors may also be presumed to be independent assuming there are no personal or external impairments if they are:

1. Elected by the citizens of their jurisdiction.
2. Elected or appointed by and reporting to the legislative body of the level of government to which they are assigned.
3. Appointed by the chief executive and confirmed by and reporting to the legislative body of the level of government to which they are assigned.

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1 An exception might be the new inspector general within the Federal Government. The inspector general, by law, has certain reporting responsibilities to the Congress, including reporting the results of in-house audits. This removes some of the organizational impairments. A parallel example would be a local auditor who, although an employee of the local government, reports to both the legislative board or council and the top local official.

OFFICE OF MANAGEMENT AND BUDGET
Circular A-102, "Uniform Administrative Requirements for Grants-In-Aid to State and Local Governments"

AGENCY: Office of Management and Budget.

ACTION: Final Policy.

SUMMARY: This notice revises OMB Circular A-102 by replacing paragraph 2h. Attachment G with a new Attachment P entitled "Audit Requirements." The revision originated from a Presidential initiative to streamline Federal aid, and is another part of OMB's system of guidance for federally assisted programs. One area the President highlighted as having a substantial need for improvement was audit of federally assisted programs. He directed Federal departments and agencies to improve audit coordination, and to increase their reliance on audits made by State or local governments. This revision sets forth the audit requirements for State and local governments and Indian tribal governments receiving Federal assistance. It provides for independent audits of financial operations including compliance with certain provisions of Federal law and regulation. The requirements are established to insure that audits are made on an organization-wide basis rather than a grant-by-grant basis.

EFFECTIVE DATE: This revision becomes effective October 22, 1979.


SUPPLEMENTARY INFORMATION: On July 11, 1978, a notice was published in the Federal Register (43 FR 40824-25) to amend Circular A-102. Interested persons were invited to submit written comments by September 11, 1978. About fifty comments were received from Federal agencies, State and local governments, professional associations, and others. The comments were considered in developing these final regulations. Although almost all commenters agreed with the concept of a single audit, some raised questions or made suggestions for clarifying changes. The more significant comments received, and OMB's responses to them are discussed below.

Changes in Final Regulation

Set forth below are changes that have been adopted in the final regulations. The paragraphs are keyed to the proposed regulations published on July 11, 1978.

1. Paragraph 1 has been amended to make the Attachment applicable to Indian tribal governments. This paragraph was also changed to make it clear that one of the objectives of the audit was to determine if financial reports to the Federal Government contain accurate and reliable data.

2. Paragraph 2. The definition of "cognizant agency" was added to this paragraph, and is now used uniformly throughout the Attachment.

3. Paragraph 3 was amended to provide that contracts awarded by recipients for audit services shall include a reference to this Attachment. Also, the paragraph was further divided into two separate paragraphs for clarity.

4. Paragraph 5. A clause was added to make it clear that the auditor should make a determination that the financial statements are presented fairly and in accordance with generally accepted accounting principles.

5. Paragraph 7. The phrase "at scheduled intervals" was deleted for clarity.

6. Paragraph 8 was changed to make it clear that, in the event irregularities are found, management officials above the level of involvement should be notified.

7. Paragraph 9 was restructured and reworded to clarify its intent. Also, a change was made to make it clear that auditors need express a positive assurance only with respect to items tested.

8. Paragraph 10 was amended to require cognizant agencies to notify auditors in writing when the three-year retention period for workpapers needs to be extended.

9. Paragraph 13. A sentence was added to make it clear that auditors are responsible for distributing audit reports to their program officials.

10. Paragraph 14. Changes were made to make it clear that this paragraph covered only State and local governments and Indian tribal governments. Also, the recipient's responsibilities with respect to subrecipient audits are more clearly delineated.

Suggested Changes Not Considered Necessary

Comment. Several commenters felt that there were conflicts between Attachment P and audit guidelines issued by the General Accounting Office.

Response. The GAO guidelines are currently being reviewed to assure consistency of policy.

Comment. Several commenters were concerned with the provisions of the Attachment requiring comments on the accuracy of financial reports. This requirement, they said, would require the examination of every transaction processed by a governmental entity.

Response. It was never intended that a hundred percent examination would be routinely required. We believe this is clear from other provisions of the Attachment.

Comment. One commenter said it was not clear whether an auditor should automatically expand the scope of audit and secure additional data to support the disclosure of irregularities in the audit report.

Response. The Attachment does not provide for automatically expanding the scope of audit work. This is a matter that would have to be worked out between the auditor, the cognizant agency, and the recipient.

Comment. Several commenters recommended that the Attachment contain a definition of the term "independent."

Response. The Attachment incorporates by reference the Standards for Audit of Governmental Organizations, Programs, Activities, and Functions published by the General Accounting Office. Chapter 3 of these standards discusses the standard of independence in some detail.

Comment. Several commenters said that additional audit costs would be incurred to achieve full compliance with the Circular. They suggested that the mechanism for funding these audits be addressed in the Attachment.

Response. Circular 76-4, "Cost principles for grants to State and local governments," establishes rules for determining allowable costs. This Circular provides that the cost of audits is allowable.

Comment. One commenter suggested that each grant application should contain a certification that arrangements will be made for the audits prescribed by the Circular. Failure to furnish an acceptable audit as determined by the cognizant agency could be a basis for denial of Federal funds.

Response. The grant application forms prescribed by Circular A-102 now contain an assurance that the applicant will comply with all the provisions of the Circular. We do not believe it is necessary to single out the audit requirements for a separate certification.

Comment. One commenter said the Attachment requires an audit every two years, and asked whether that meant...
that only every other year's transactions should be audited.

Response. It is the intent of the Circular that audits cover the period since the previous audit. If this is a two-year period, the audit should cover both years.

James T. McIntyre, Jr.
Director.
Circular A-182
Attachment P—Audit Requirements

1. This Attachment establishes audit requirements for State and local governments, and Indian tribal governments that receive Federal assistance. It provides for independent audits of financial operations, including compliance with certain provisions of Federal law and regulation. The requirements are established to issue that audits are made on an organization-wide basis, rather than on a grant-by-grant basis. Such audits are to determine whether (a) financial operations are conducted properly, (b) the financial statements are presented fairly, (c) the organization has complied with laws and regulations affecting the expenditure of Federal funds, financial transactions and accounts, and financial statements and reports of recipient organizations. These examinations are to determine whether:

a. There is effective control over and proper accounting for revenues, expenditures, assets, and liabilities.

b. The financial statements are presented fairly in accordance with generally accepted accounting principles.

c. The Federal financial reports (including Financial Status Reports, Cash Reports, and claims for advances and reimbursements) contain accurate and reliable financial data; and are presented in accordance with the terms of applicable agreements, and in accordance with Attachment H of this Circular.

d. Federal funds are being expended in accordance with the terms of applicable agreements and those provisions of Federal law or regulations that could have a material effect on the financial statements or on the awards tested.

7. In order to accomplish the purposes set forth above, a representative number of charges to Federal awards shall be tested. The test shall be representative of (1) the universe of Federal awards received, and (2) all cost categories that materially affect the award. The test is to determine whether the charges:

a. Are necessary and reasonable for the proper administration of the program.

b. Conform to any limitations or that could have a material effect on the unqualified opinion cannot be expressed, state the nature of the qualification.

c. The auditors' comments on compliance and internal control which should:

(1) Include comments on weaknesses in and noncompliance with the systems of internal control, separately identifying material weaknesses.

(2) Identify the nature and impact of any noted instances of noncompliance with the terms of agreements and those provisions of Federal law or regulations that could have a material effect on the financial statements and reports.

(3) Contain an expression of positive assurance with respect to compliance with requirements for tested items, and negative assurance for untested items.

d. Comments on the accuracy and completeness of financial reports and claims for advances or reimbursement to Federal agencies.
e. Comments on corrective action taken or planned by the recipient.

11. Work papers and reports shall be retained for a minimum of three years from the date of the audit report unless the auditor is notified in writing by the cognizant agency of the need to extend the retention period. The audit workpapers shall be made available upon request to the cognizant agency or its designee and the General Accounting Office or its designee.

12. The Office of Management and Budget will work with Federal agencies and State and local governments to assure that recipient audits are made in accordance with the standards set forth in paragraph 5.

13. The Office of Management and Budget will designate cognizant agencies for major recipient organizations.

14. The cognizant agency shall have the following responsibilities:
   a. Obtain or make quality assessment reviews of the work of non-Federal audit organizations and provide the results to other interested audit agencies. (If a non-Federal audit organization is responsible for audits of recipients that have different cognizant audit agencies, a single quality assessment review should be arranged.)
   b. Assure that all audit reports of recipients that affect federally assisted programs are received, reviewed, and distributed to appropriate Federal audit officials. These officials will be responsible for distributing audit reports to their program officials.
   c. Whenever significant inadequacies in an audit are disclosed, the recipient organization will be advised and the auditor will be called upon to take corrective action. If corrective action is not taken, the cognizant agency shall notify the recipient organization and Federal awarding agencies of the facts and its recommendation. Major inadequacies or repetitive substandard performance of independent auditors shall be referred to appropriate professional bodies.
   d. Assure that satisfactory audit coverage is provided in a timely manner and in accordance with the provisions of this attachment.
   e. Provide technical advice and act as a liaison between Federal agencies, independent auditors, and recipient organizations.
   f. Maintain a followup system on audit findings and investigative matters to assure that audit findings are resolved.
   g. Inform other affected audit agencies of irregularities covered. The "hit list" agencies in turn shall inform appropriate officials in their agencies. State or local government law enforcement and prosecuting authorities shall also be informed of irregularities within their jurisdiction.

15. Recipients shall require subrecipients that are State and local governments or Indian tribal governments to adopt the requirements in paragraph 1 through 11. above. The recipient shall ensure that the subrecipient audit reports are received as required, and shall submit the reports to the cognizant agency. The cognizant agency will have the responsibility for these reports described in paragraph 14.

(Also see paragraph 16, page 7.)
The following paragraph was added to Attachment P--Audit Requirements on September 2, 1980.

16. Small business concerns and business concerns owned and controlled by socially and economically disadvantaged individuals shall have the maximum practicable opportunity to participate in the performance of contracts awarded with Federal funds. Grantees of Federal funds shall take the following affirmative action to further this goal:

a. Assure that small audit firms and audit firms owned and controlled by socially and economically disadvantaged individuals as defined in P.L. 95-507 are used to the fullest extent practicable.

b. Make information on forthcoming opportunities available, and arrange time frames for the audit so as to encourage and facilitate participation by small or disadvantaged audit firms.

c. Consider in the contract process whether firms competing for larger audits intend to subcontract with small or disadvantaged firms.

d. Encourage contracting with small or disadvantaged audit firms which have traditionally audited government programs, and in such cases where this is not possible, assure that these firms are given consideration for audit subcontracting opportunities.

e. Encourage contracting with consortiums of small or disadvantaged audit firms as described in paragraph a. when a contract is too large for an individual small or disadvantaged audit firm.

f. Use the services and assistance, as appropriate, of the Small Business Administration, the Minority Business Development Agency of the Department of Commerce, and the Community Services Administration in the solicitation and utilization of small or disadvantaged audit firms.